

41 T.C. 582 (1964)

MARTIN MAYRATH AND ROSE MAYRATH, PETITIONERS,
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 93674.

United States Tax Court.

Filed January 28, 1964.

Adam Y. Bennion and J. Edwin Fleming, for the petitioners.

Thomas J. Moroney, Jr., for the respondent.

Petitioner, contending to be in the trade or business of inventing, constructed an alleged "experimental" house at a cost of \$287,474.11 for his family's personal use and occupancy. Assuming that a similar luxury house without experimental features could be constructed for \$116,520, petitioner deducted for the years 1956 and 1957 the cost in excess of that amount as research and experimental expenses under sec. 174, I.R.C. 1954. *Held:*

1. Such expenditures were not connected with a trade or business and were not of a research and experimental nature within the intendment of the statute.
2. Other miscellaneous trade or business expense deductions denied for lack of substantiation.

583 *583 DAWSON, Judge:

Respondent determined deficiencies in petitioners' income tax as follows:

<i>Taxable year</i>	<i>Deficiency</i>
1955 -----	\$12,265.71
1956 -----	42,107.33
1957 -----	26,933.46

The principal issue presented is whether petitioners are entitled to deduct for 1956 and 1957 a portion of the cost of their personal residence as research and experimental expenses under section 174 of the Internal Revenue Code of 1954.

In his notice of deficiency respondent disallowed for the years 1955, 1956, and 1957 various other business expenses under 12 classifications. Respondent has agreed that petitioners have substantiated and are entitled to deduct \$44,926.74 of those expenses. Petitioners have conceded that respondent properly disallowed deductions in the amount of \$16,500.56. There remain in dispute expenses for the years in issue in the following amounts:

	1955	1956	1957
Business service -----	\$400.00		
Engineering and other technical services -----	3,350.00		
Research and experimental -----		\$2,022.62	\$1,904.43
Use of residence ¹ -----	1,072.96	3,072.46	3,365.40

¹ Included in this category are depreciation deductions for petitioner's office and shop building in the amounts of \$700 and \$2,100 for the years 1956 and 1957, respectively.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are herein incorporated by this reference.

During the years in issue, petitioners, Martin Mayrath and Rose Mayrath, were husband and wife, residing in Dallas, Tex. They filed joint individual income tax returns for the taxable years 1955, 1956, and 1957 with the district director of internal revenue, Dallas, Tex., on the calendar year basis and cash basis of accounting. Petitioners are now divorced and Martin Mayrath (hereinafter referred to as petitioner) resides at 10707 Lennox Lane, Dallas, Tex., and the last known address of Rose Mayrath is 4921 Northaven Road, Dallas, Tex.

After graduating from Kansas State College in 1932, petitioner was at different times employed as an automobile and insurance salesman, an accountant, and a recorder and computer for the U.S. Coast and Geodetic Survey. Upon the death of his father in 1939, petitioner returned to his family's farm near Dodge City, Kans. While engaged in farming activities he experimented with grain augers. In 1944 he and his brothers bought an interest in a farm implements business and began building grain augers to sell. Their franchise was canceled *584 when the building burned but petitioner and his brothers continued in the augers business.

On September 27, 1949, petitioner acquired a United States patent on his grain auger. He subsequently acquired patents on the auger in Argentina, Australia, and Canada. During the years 1951 through 1963 petitioner acquired United States patents on a mobile power-operated conveyor, an articulated conveyor apparatus, a conveyor trough joint, and an auger conveyor carriage. Through the years petitioner has applied for or instituted searches preliminary to applying for numerous other patents, most of which are exclusively or primarily related to farming implements such as augers, corn and hay elevators, conveyors, and crop sprayers.^[1]

During 1955, 1956, and 1957 petitioner owned, directly or indirectly, all the stock of six corporations engaged in either manufacturing, selling, or distributing Mayrath crop sprayers, augers, and hay and corn elevators. Mayrath Machinery Co., Inc., Dodge City, Kans., is engaged in manufacturing the grain augers or loaders covered by petitioner's initial patent. Mayrath, Inc., Dodge City, Kans., is a sales and export corporation primarily for Mayrath products. Mayrath Co., Compton, Ill., manufactures the corn and hay elevators, crop sprayers, and bale movers developed by petitioner. Mayrath Southern Co., Memphis, Tenn., is a warehousing and distributing company for Mayrath products and other products. Mayrath, Ltd., a Canadian corporation located at Regina, Saskatchewan, distributes Mayrath products in Canada. Mayrath Corp., Minot, N. Dak., is the warehousing and distributing corporation for Mayrath products for the Northern United States.

Deals with the Mayrath corporations, i.e., sale of the auger patent to Mayrath Machinery Co., Inc., interest on the unpaid balance of the patent sale and on loans to the corporations, and salaries, account for approximately \$485,000 of the \$530,000 gross receipts reported by petitioners for the 3 years in issue. The remaining receipts were from oil interests, a partnership interest, dividends, and a music business.

Petitioner had gross receipts of \$719 for the 3-year period from Christopher Music Co., Los Angeles, Calif. The business was organized in 1953 primarily to publish music and promote tunes written by petitioner's two partners. As a sideline, the partners experimented with multiple sounds, echo chambers, record changers, a method of printing music which would eliminate separate printings for each orchestral instrument, a metal piano, and a piano requiring little pressure for children to play. Petitioner's two partners subsequently *585 withdrew from the business which was practically dormant during the years in issue — the only income being a negligible amount of royalty income.

The music studio was closed in the early part of 1954 and files, records, musical instruments, and equipment were moved to a personal residence owned by petitioner in Los Angeles. During 1955, 1956, and until the sale of the residence in 1957, the Los Angeles residence was vacant except for music equipment. During such time petitioners and their five children resided at 11038 Cinderella Lane, Dallas, Tex. Petitioner was in Los Angeles for a very limited period of time on no more than three occasions during the years in issue.

The Cinderella Lane residence had three bedrooms, a very small kitchen, a combination living room and dining room, a laundry room, and a hall. Petitioner kept a desk, filing cabinets, and music apparatus at the residence. After petitioners moved during the latter part of 1957, the Cinderella Lane house was used only for storage.

In 1956 petitioner commenced the construction of a residence at 10707 Lennox Lane, Dallas, Tex., which was to constitute the petitioners' home. An architect was hired to draw up the plans and a general contractor was hired to handle the workmen, keep books and records, and supervise the construction. Petitioner worked closely with the contractor and made

most of the decisions regarding the construction. His primary concern was to assure that his personal design and ideas be carried out. Petitioner's prior building experience was limited to his assisting in the planning and designing of factories, warehouses, and offices for his corporations, i.e., industrial or commercial building. Petitioner has never been engaged in the construction business for profit.

The Lennox Lane residence was completed in 1957 at a total cost of \$287,474.11. It is a two-story building containing 5,826 square feet with a large carport attached on the front. It has a large entrance hall, a living room, dining room, bar, kitchen, and accessory room on the first floor. The second floor consists of six bedrooms, five bathrooms, and an equipment room for heating and air conditioning equipment. It has a stairway from the entrance hall to the second floor and a back stairway.

Exterior to the house are a tennis court, swimming pool, bath house, and adjoining cabana-type sitting area. The swimming pool area is enclosed by a chain link fence with one entrance gate.

Petitioner's home contains many innovations some of which are not normally found in residences and others which are normally found only in luxury residences.

586 The house contains no wood. The basic construction consists of concrete piers set on a 4-foot bed of solid rock which underlies the *586 property. Steel columns, 4 inches in diameter, are set on top of the concrete piers, each column having a bearing plate for the first floor, the second floor, and the roof. The steel columns, approximately 30 in number, extend 17 or 18 feet in the air and are painted with aluminum paint or covered with light gauge aluminum trim. The first floor, second floor, and roof are concrete slabs that were poured in place. The exterior walls are solid plate glass from floor to ceiling on the east side of the house; stone veneer on the north and west sides; and brick with stone veneer, Stran-Steel with stone veneer, and solid stone with brick filler on the south side. The interior walls are made of Stran-Steel studding covered with sheetrock.

Some of the unusual or luxury features of the house are: The use of glass, plastics, and aluminum in lieu of wood; a chilled and heated water air conditioning and heating system with zone control and automatic changeover from heating to cooling; two thermostatically-controlled, circulating hot water systems—one for kitchen use and one for bathroom use; aluminum doors, door frames, baseboards, and window sills; ultra modern kitchen with electronic oven; hanging, helicoid-shaped, concrete stairway with aluminum and glass banister; indirect lighting; three- and four-way light switches with dimmers; three-way switches on motor-operated drapes; telephone system with 4 lines and 12 extensions; intercom system; polished plate glass dining room table anchored in concrete floor; built-in glass and aluminum bookcase; kitchen cabinets suspended on vertical aluminum pipes; deck with aluminum railing around most of the second floor; automatic lawn flooding system; palm tree with automatic warming coil in planter; and filtering system for the swimming pool.

Several problems were encountered in the construction of the residence due in full or in part to the use of aluminum, glass, plastics, and steel in lieu of wood. There were difficulties in obtaining fasteners for affixing glass to stone or metal and fittings that would allow expansion and yet prevent air and water leakage. Problems subsequently developed with the automatic changeover for air conditioning and heating and with the lawn flooding system. Flooding occurred in the electric conduits located in the floor causing shorts in the wiring.

587 Petitioner built and maintains an office or shop building on the Lennox Lane property joined to the main residence by a covered walkway. The shop is a one-story building 20 feet by 40 feet with a concrete slab floor and Stran-Steel roof. Three sides of the building are glass and the rear side is concrete with stone veneer. There is one partition separating the front of the building from the rear where petitioner keeps tools and machinery. Wires for electricity and phones are in conduits in the floor. The air conditioning and heating *587 of the shop runs off the residence cooling and heating system connected by underground pipes.

No action was taken during the construction or immediately thereafter to exploit any of the ideas, designs, or features used in the construction of petitioner's residence. On July 1, 1960, some 3 years after the house was completed, petitioner mailed a letter concerning the house to seven metal and steel manufacturing companies. The letter explained some of the "experimental" features of the house, beginning with the statement that the house contained no wood. Pictures of the house were enclosed. Inquiry was made as to whether the various companies would be interested in or able to assist in marketing finished trim materials, plans, tools, clips, and fasteners. Representatives were invited to examine the house. Further correspondence with some of the companies resulted in no agreements to assist petitioner in exploiting his ideas.

OPINION

Whether petitioners are entitled to deduct a portion of the cost of their personal residence as a research and experimental expenditure under section 174 of the 1954 Code^[2] is the primary issue for decision.

In preparing their 1956 individual income tax return, petitioners estimated a total expenditure of \$286,000 in the construction of their uncompleted residence which was to contain 5,826 square feet. Assuming that a luxury residence would cost \$20 per square foot, petitioners multiplied the total square feet by \$20 and arrived at a cost of \$116,520 for a luxury residence "without experimental features." Deducting this sum from the estimated cost of \$286,000, petitioners labeled the difference of \$169,480 as the portion of the total cost attributable to research and experimental expenditures. On their 1956 income tax return petitioners reported expenditures for such year of \$124,663.35. Of this amount they deducted 59.3 percent (\$73,925.37) as experimental expenditures, such percentage being the ratio of the total amount allocable to research and experimental expenditures *588 (\$169,480) to the total estimated cost (\$286,000). To this \$73,925.37 amount petitioners have added \$4,000 which they have designated "contractor's accounting expense paid to record costs of special construction."

The construction of the residence having been completed by the end of 1957, petitioners contend that they were then able to establish the exact cost of such construction as \$287,474.11. Following the same procedure used in 1956, petitioners deducted \$116,520, the cost of constructing a residence of 5,826 square feet at a cost of \$20 per square foot, from the total construction cost of \$287,474.11. The balance of \$170,954.11 allegedly represented the total cost allocable to research and experimental expenditures. Taking 59.5 percent of the \$162,810.76 construction expenditure for 1957, such percent being the ratio of the total amount allegedly incurred for research and experimental expenses (\$170,954.11) to the total cost of construction (\$287,474.11), petitioners arrived at a deduction for 1957 of \$96,872.40. Petitioners thus deducted for the years 1956 and 1957 a total of \$174,797.77 as a research and experimental expense attributable to the construction of their personal residence.^[3]

In his statutory notice of deficiency, respondent disallowed the deduction for each year "because it does not constitute a research and experimental expense within the meaning of the Internal Revenue Code." We agree with the respondent.

The specific provision for the deduction of research and experimental expenses was first enacted in the Internal Revenue Code of 1954 as section 174. Under this section taxpayers may elect to deduct research and experimental expenditures which are paid or incurred during the taxable year in connection with a trade or business. The statute specifically eliminates from treatment thereunder all expenditures for the acquisition or improvement of land and depreciable or depletable property which is "to be used in connection with the research or experimentation." The regulations promulgated under section 174 provide that where research by a taxpayer creates, as an end product, "depreciable property to be used in the taxpayer's trade or business," the taxpayer is permitted to deduct only that portion of the expenditures connected with the development of the depreciable property which may be attributed to research; and research expenditures do not include *589 "the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property." Sec. 1.174-2(b)(2) and (4), Income Tax Regs.

It is clear that the intent of Congress in enacting section 174 was to give taxpayers the option of treating research and experimentation expenditures in much the same manner as ordinary and necessary business expenses deductible under section 162 of the 1954 Code and to encourage taxpayers to carry on research and experimentation. See S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. 591), 83d Cong. 2d Sess., p. 33 (1954). However, to apply the benefits of section 174 to the situation at hand where petitioner seeks to deduct a portion of the cost of an "experimental" house which he and his family personally occupied, even though he professes to be in the trade or business of inventing, would, in our opinion, plainly violate the spirit and intent of the statute and produce an absurd result.

First, we find, as the statute requires, that petitioner has failed to connect the construction of his residence with a trade or business. To a degree he is unquestionably an inventor, as evidenced by the various patents which he has obtained and for which he has applied. With very few exceptions, however, these patents are directly or indirectly related to farming implements of one kind or another; and it is from these particular patents that petitioner has realized income either directly or through his corporations. Whether or not petitioner's work in connection with the invention and development of farming implements places him in the trade or business of inventing, we are completely unwilling to consider as a part of such trade

or business his activities in building an "experimental" house for his own family's occupancy and in building factories, warehouses, and offices for the use of his wholly-owned corporations.

Moreover, petitioner's actions during the construction of the house and following its completion do not bear out any intention to use the house or any of its features in the furtherance of a trade or business. Although we assume that in building a house containing no wood the petitioner mastered some of the construction problems involved, he has not shown that he intends to use such knowledge in the business of constructing residential homes or how he would do so if that were his intention. The only effort he made in that direction was to send letters describing the house and some of its features to several metal manufacturers some 3 years after the house was completed and at about the same time petitioners' income tax returns for the years before us were being audited by the Internal Revenue Service.

590 In *John F. Koons*, 35 T.C. 1092 (1961), we stated that the statutory phrase "trade or business" presupposes an existing business with which the taxpayer is directly connected and that expenditures for *590 research and experimentation that are preliminary to the establishment of a business do not qualify as deductions under section 174. We think the statute was intended to be used in the realistic and practical sense of a *going* trade or business — a condition which does not exist here. Certainly the petitioner is not in the trade or business of constructing residences, and his attempt to relate such construction activities to other alleged trades or businesses is totally insufficient.

It is our further view that petitioners' expenditures in connection with their "experimental" house are not of a research and experimental nature within the intendment of the statute. In the absence of statutory definition, the regulations under section 174 define "research and experimental expenditures" to mean expenditures "which represent research and development costs in the experimental or laboratory sense."^[4] We find the regulatory definition to be reasonable and consistent with the intent of the statute to limit deductions to those expenditures of an investigative nature expended in developing the *concept* of a model or product. We doubt that such was the nature of petitioners' expenditures for the actual *construction* of their "model" residence. And although petitioners have included in their 1956 deduction for research and experimental expense \$4,000 for "contractor's accounting expense paid to record costs of special construction," which would seem to enable them to identify specific items of costs due to experimentation, they have resorted to a method of arriving at experimental costs by presuming without convincing proof that a similar house without experimental features would cost \$20 per square foot and that the cost in excess of that amount is due to experimentation. This method of calculating research costs lacks the identification of specific expenditures and fails to assure that costs of materials, labor, and other component elements of construction are not also included therein.

591 Finally, the experimental nature of the house itself is open to question. It may be true that, in petitioner's mind, some of the ideas were new, unique, or involved special problems. But the record as a whole reveals that many of the so-called "experimental" features were either catalog or luxury items and that the special problems encountered were often the result of unusual combinations of materials, modifications *591 of standard construction principles, or the utilization in residential construction of certain features commonly used in commercial construction.

Even if we were to assume that it is petitioner's business merely to "invent," there is a point beyond which his propensity to experiment must be viewed as taking on the characteristics of a hobby. At any rate, in the light of all these evidentiary facts and circumstances, we are not convinced that the cost of constructing petitioners' residence, unusual as it may be, is other than a personal living expense prohibited from deduction by section 262 of the 1954 Code.^[5]

In addition to the claimed research and experimental expenses relating to the construction of the residence, there remain in dispute portions of three items of expense classified on petitioners' income tax returns as research and experimental, business service, and engineering and other technical services. Petitioner's testimony as to these items is vague and unsatisfactory. While he testified as to some of the items from checks and invoices, none of which are in evidence, we have only his general statement that the alleged expenditures were in fact paid.

He was unable to connect the alleged expenditures to a particular trade or business or to a specific project. Although petitioner claims to have attempted to allocate and to separate the expenditures for the construction of his house, which were claimed elsewhere, from expenditures for other projects, he admits that there is some commingling and overlapping. Indeed, most of the items of material included in the category of "research and experimental" are suitable for use in a residence or for other personal use.

The claimed expenditures in the year 1955 for engineering and technical services in the amount of \$3,350 and for business services in the amount of \$400 arise from purported payments to Truitt Bishop from whom petitioner purchased his Cinderella Lane residence and who drew the plans for the Lennox Lane residence. Even though petitioner testified that portions of the amounts were for payment on the residence bought from Bishop, for a large telephone bill, and for architect fees, he attempts to justify deducting as a business expense the full amounts paid to Bishop on the theory that certain other unrelated expenses such as legal and accounting fees could have been deducted but were not. Suffice it to say, this type of "allocation" is wholly inadequate from our standpoint.

592 Also in dispute are deductions of \$1,072.92, \$3,072.46, and \$3,365.40, taken by petitioners during the respective calendar years 1955, 1956, *592 and 1957 for the use of their residences for business purposes. During 1955, 1956, and the first 7 months of 1957, petitioners lived in the Cinderella Lane house in Dallas. They owned the California house during 1955, 1956, and the first month of 1957 at which time it was sold. They lived in the Lennox Lane residence for 5 months of 1957. Petitioner alleges to have made a room-by-room analysis of the contribution of each house to business use and arrived at percentages of one-third for the California house for 1955 and 1956, one-half for the Cinderella house for 1955 and 1956, and one-third for the Cinderella and Lennox Lane houses for 1956 and 1957. Purporting to be conservative, he then deducted for these years three-fourths of the above percentages of the "cost" of each residence. There is nothing to show what "cost" is, i.e., whether cost of expenditures for utilities and upkeep or cost of improvements or both. And while attempting to describe the formula employed at arriving at the amounts deducted, petitioner has failed to substantiate total expenditures in any manner and has made no attempt to state the actual business uses to which the residences were employed. Furthermore, considering the sizes of the houses and the size of petitioner's family, it appears unlikely that he could have devoted such large portions of his residences to business use.

Included in such deductions for the years 1956 and 1957 were the sums of \$700 and \$2,100, respectively, applicable to depreciation on the shop office located at the Lennox Lane address. We have set forth in our Findings of Fact a detailed description of the building. While the petitioner testified that the office was constructed at a cost of \$42,000, there is no supporting documentary evidence showing the cost of materials, labor, et cetera. It has not been established whether the alleged cost was also included in the total cost of the Lennox Lane residence, and petitioner's only testimony regarding the useful life of the office building is, "We will probably tear it up in 20 years." It is inconceivable, however, that this 1-story 20 by 40 feet structure built on a concrete slab, and located in a residential rather than a business area, would have cost \$42,000. With the scanty evidence adduced we are unwilling to accept petitioner's statements alone and we have been given no other basis upon which to determine an allowance for depreciation. Accordingly, we find that petitioner has not substantiated his claim to deductions for the business use of his residence and depreciation on the shop building.

593 As to the other items in question, respondent has allowed deductions in each category which are substantial and, in our opinion, reasonable and adequate to cover petitioner's business expenses. Out of total business expenses of \$76,615.17 claimed on their income tax returns for these years the respondent allowed \$44,926.74. Therefore, we conclude *593 that petitioner has failed to meet his burden as to the additional amounts he claims and has failed to show that such expenses were other than personal. See Rushing v. Commissioner, 214 F. 2d 383 (C.A. 5, 1954), affirming a Memorandum Opinion of this Court.

In order to reflect the agreements of the parties as to other items,

Decision will be entered under Rule 50.

[1] Among the items with no pending patent applications are such innovations as a "beep transmitter" for retrieving lost animals or children, an automatic lawn flooding system, and a "musicolor system" for printing orchestral music — items totally unrelated to petitioner's primary interest, i.e., farm implements.

[2] SEC. 174. RESEARCH AND EXPERIMENTAL EXPENDITURES.

(a) TREATMENT AS EXPENSES.—

(1) IN GENERAL.—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

* * * * *

(c) LAND AND OTHER PROPERTY.—This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion); but for purposes of this section allowances under section 167, and allowances under section 611, shall be considered as expenditures.

[3] During the course of the trial, petitioners conceded additional amounts of \$7,500 and \$35,000 for 1956 and 1957, respectively, as being nondeductible as research and experimental expenditures. Such concessions are purported to eliminate from the claimed research and experimental deductions the cost of such items as carpeting, draperies, landscaping, swimming pool, and tennis courts.

[4] Sec. 1.174-2 Definition of research and experimental expenditures.

(a) *In general.* (1) The term "research or experimental expenditures", as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. * * *

[5] SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

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